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Part 14 – Too Much of a Compromise?

Defining Classes for Creditor Compromise Approval

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I Table of Contents

I		*TABLE OF CONTENTS*	*2*
II		*INTRODUCTION*	*3*
III		*OUTLINE*	*4*
IV		*PART 14 COMPROMISES WITH CREDITORS*	*5*
V		*BANK OF TOKYO-MISTUBISHI, UFJ LTD V SOLID ENERGY NEW ZEALAND LTD*	*6*
	A	*Financial Position of Solid Energy*	*6*
	B	*The Compromise Proposals*	*6*
	C	*Third Cause of Action: The Class Issue*	*7*
	D	*Solid Energy's Liabilities*	*8*
	E	*Voting Power in Compromises Proportionate to Debt Attribution*	*9*
	F	*Arrangements of Creditor Classes – BTMU's Arguments*	*9*
VI		*COMMON LAW CREDITOR CLASS PRINCIPLES*	*11*
	A	*The Original Formulation of the "Common Interests" Test*	*11*
	B	*The Comparator Rights Analysis*	*12*
VII		*APPLICATION ON THE SOLID ENERGY FACTS*	*13*
	A	*Validity of Classing Term Debt and Contingent Debt Together*	*13*
	B	*Comparator Rights Analysis and the Approach of Winkelmann J.*	*15*
VIII		*OVERVIEW OF STATUTORY COMPROMISE REGIMES IN THE UK AND AUSTRALIA*	*18*
	A	*United Kingdom*	*18*
	B	*Australia*	*19*
	C	*Differences from New Zealand Procedure*	*20*
IX		*POSSIBLE MODIFICATIONS FOR THE STATUTORY REGIME*	*22*
	A	*The Need for Reform – Overview*	*22*
	B	*History of Part 14*	*22*
	C	*Unsatisfactory Current Protection for Minority Creditors*	*23*
X		*OPTIONS FOR REFORM*	*25*
	A	*Court Sanction Requirement*	*25*
	B	*A Separate Regime for Certain Types of Companies*	*26*
	C	*Limitation of Part 14 to Small Companies or a Maximum Amount of Debt Owing*	*26*
	D	*Increased Threshold for Creditor Approval*	*27*
	E	*The Preferable Option*	*28*
XI		*CONCLUSION*	*28*
XII		*BIBLIOGRAPHY*	*30*

Abstract

In 2013, the Auckland High Court delivered New Zealand's leading judgment on the compromise with creditors process set out in Part 14 of the Companies Act 1993. In particular, the Court considered the way in which different classes of creditors might be grouped together for the purposes of approving a compromise arrangement. This essay considers the cogency of the Court's conclusion on the class issue. It concludes that the outcome was possibly incorrect and that the Part 14 process warrants some legislative clarification.

Key Words: *"compromise", "creditor", "class"*

II Introduction

The premise that altering the obligations that an insolvent or near-insolvent company owes to third parties is often economically preferable to liquidation has been well established in New Zealand law since 1882.[1] Part 14 contains one of three corporate rescue mechanisms in the Companies Act 1993, all of which are designed to rehabilitate a company that is unable to pay its debts within the meaning of s 287.[2]

Part 14 details the procedure whereby a three-fourths majority of a company's creditors, or of a class of a company's creditors, may approve a compromise proposal, which will become binding on all creditors, or all creditors within that class.[3] Unlike Part 15, which sets out a procedure whereby application may be made to the High court for approval of a compromise, a Part 14 compromise does not require a court sanction to become binding.[4] Section 232(3)[5] sets out the three grounds upon which a creditor may apply to the court for an order that the creditor is not bound by an approved compromise. However, the hallmark of a Part 14 compromise is that

[1] John H Farrar Susan Watson and Lynne Taylor *Company and securities law in New Zealand* (2nd ed, Brookers, Wellington, 2013) at 719.
[2] Companies Act 1993, s 287.
[3] Companies Act 1993, s 230(1).
[4] Farrar Watson and Taylor, above n 1, at 719.
[5] Companies Act 1993, s 232(3).

dissident creditors are bound by the compromise, notwithstanding the lack of a court sanction.

The Part 14 procedure has been rarely used. This is partly due to there being no automatic moratorium on creditor claims against the company, pending approval or disapproval of the compromise.[6] It was however used recently by the board of Solid Energy Limited, in an attempt to trade out of financial difficulties. A major creditor voted unsuccessfully against the proposals and later issued proceedings against the company. *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd*[7] (*Solid Energy*) required the court to consider some important issues of detail concerning the operation of Part 14. In particular, that decision exposed the potential for a debtor company to manipulate the classification of creditor classes in order to obtain approval of a compromise.

III Outline

This essay addresses the most contentious issue in *Solid Energy*, which was the validity of the separation of creditor classes for the purposes of s 230(1) of the Companies Act 1993. The essay gives a brief overview of the nature of Part 14 compromises. It then discusses the creditor class separation issue in *Solid Energy* with reference to the submissions of the parties. It then considers the cogency of the decision in *Solid Energy*, with reference to the approaches of the Australian and English courts, which are based on the similar case law. It also specifically details the alternative outcomes in relation to the compromise proposals, had the classes been organised in the way the dissident creditor argued that they should have been.

This essay suggests that the conclusion in *Solid Energy* on this issue may have been incorrect, or was at least undesirable and unfair. Consequently, the essay explores the options for clarification through legislative reform of the Part 14 creditor compromise process to ensure better protection of minority creditors' rights.

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[6] Farrar Watson and Taylor, above n 1, at 720.

[7] *Bank of Tokyo-Mitsubishi UFJ, Ltd v Solid Energy New Zealand Ltd* [2013] NZHC 3458 [*Solid Energy*].

IV Part 14 Compromises With Creditors

A board of directors, receiver, liquidator or alternatively a shareholder or creditor may propose a compromise scheme under Part 14.[8] The proposer must have reason to believe that the company is or will be insolvent within the meaning of s 287.[9] The inability to pay debts threshold for using Part 14 is expressed in terms of cash flow insolvency.[10] However, following the *Solid Energy* decision it appears that Part 14 may also cover proposals designed to resolve fundamental balance sheet weaknesses, due to the inherent link between balance sheet and cash flow liquidity.[11] The insolvency threshold for Part 14 was another issue addressed in *Solid Energy*, but is not relevant to the class issue discussed in this essay.

The crux of a Part 14 compromise agreement is that where three-fourths of the creditors or of a class of creditors votes in favour of a proposal, it binds all dissident creditors, or dissident creditors within the classes that are voting on the compromise.[12] Different creditor classes vote separately. Part 14 expressly states that approval of a compromise proposal is contingent on all classes voting in favour of the scheme, unless the resolution expressly states the contrary.[13] This provision functions as a safeguard against majority oppression. Conversely, it does give minority classes the power to veto the whole scheme, regardless of size.[14]

The equivalent legislation in the United Kingdom and Australia also provides for approval of creditor compromise arrangements by a three-fourths majority. However, the New Zealand creditor compromise procedure is fundamentally different from its Australian and English counterparts. These broadly equivalent schemes are contained in the Companies Act 2006[15] (United Kingdom) and the Corporations Act 2001 (Cth) (Australia).[16] They require a court order for meetings, approval by a special majority

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[8] Companies Act 1993, s 228(1).
[9] Companies Act 1993, s 287.
[10] *Solid Energy*, above n 7, at [120].
[11] At [121].
[12] At [79].
[13] Companies Act 1993, s 230(3).
[14] Michael Josling "Is Class Voting Required Under Part 15A of the Companies Act 1993?" (2011) 17 NZBLQ 492 (NZLWI) at 495.
[15] Companies Act 2006 (UK), s 896.
[16] Corporations Act 2001 (Cth) (Australia), s 411.

and a final court sanction. In contrast, application for judicial intervention in the New Zealand legislative context is limited to certain appeal grounds. The court does not oversee the process and the proposal becomes binding without a court sanction.[17]

V *Bank of Tokyo-Mitsubishi, UFJ Ltd v Solid Energy New Zealand Ltd*

A Financial Position of Solid Energy

Solid Energy, a state-owned enterprise, is New Zealand's largest coal mining company.[18] In mid 2012 the company was in serious economic difficulty following a slump in the value of and demand for coal.[19] Solid Energy had a raft of unsecured debt, plus some contingent liabilities and debts, some of which were for all intents and purposes secured. These contributed significantly to its difficult financial position.[20] Bank of Tokyo-Mitsubishi UFJ, Ltd (BTMU) lent Solid Energy $80 million on an unsecured basis under a bilateral facility agreement (the BTMU Term Debt), and was one of Solid Energy's most significant creditors.[21] The BTMU Term Debt is notable for two main reasons. A compromise proposal to alter term debt payment obligations significantly affected BTMU because of the sheer size of the BTMU Term Debt. Secondly, the value of the BTMU Term Debt dictated the power of BTMU's vote. BTMU had a significant potential veto power in relation to any compromise proposal put forward.

B The Compromise Proposals

The Solid Energy board issued two proposals to restructure its operations, designed to address its incumbent cash flow solvency issues and improve its fundamental balance sheet weakness, and thereby allow Solid Energy to trade its way out of financial difficulty. Each was conditional on the approval of the other.[22] The necessary three-

[17] Companies Act 1993, s 230.
[18] *Solid Energy*, above n 7, at [7].
[19] At [8].
[20] At [9].
[21] At [9].
[22] At [46].

fourths majority approved both proposals, which therefore bound BTMU. Voting power was proportionate to the amount of debt held by each party voting on the proposal.[23]

The first proposal concerned a rescheduling of the term debt owed to BTMU, ANZ, BNZ, CBA and Westpac under bilateral facility agreements. The date upon which the principal fell due was to be extended and the debt obligations were re-organised into a single, syndicated facility agreement. The term debt of each bank was included at full voting power. The performance bond indebtedness to ANZ, CBA and Westpac (the Performance Bond holders) totalling $58.4 million was also included at full voting power. This determined the apportionment of the voting power to each bank. The inclusion of the performance bond indebtedness in this proposal diluted BTMU's voting power to less than 25%, which meant it was unable to block the proposal.[24]

The second proposal involved a debt for equity exchange. BTMU, ANZ, BNZ, CBA and Westpac were to contribute positive equity to Solid Energy's balance sheet. Each bank was bound to exchange approximately 20% of its term debt for redeemable preference shares in Solid Energy. The performance bond indebtedness included under the first proposal was excluded. Therefore, the Performance Bond holders were apportioned less voting power under the second proposal. However, obligations owed to TSB under medium term notes were included instead. These were also to be partially exchanged for redeemable preference shares. Obligations owed to other note holders were excluded.[25] The inclusion of TSB's term notes at full voting power meant BTMU's voting power was again sufficiently diluted to stop them blocking the proposal.

BTMU voted against both proposals. A 77.7% majority approved the former, and a 78.3% majority approved the latter.[26]

C Third Cause of Action: Inadequate or Improper Definition of Classes of Creditors and Defective Service

[23] *Solid Energy*, above n 7, at [48-49].
[24] At [43].
[25] At [43].
[26] At [48-49].

BTMU brought its third cause of action under s 232(3)(b) of the Act.[27] It argued that the compromises were invalid and therefore did not bind BTMU because the classes were improperly selected.

BTMU's main submission was that the class selection for each proposal was made in an unprincipled and arbitrary manner. In essence, BTMU objected because it believed that the Solid Energy board had cherry-picked the creditors and their respective debts and lumped them into the same class to ensure that BTMU held less than 25% of the voting power and would therefore be unable to block either compromise proposal.[28]

D Solid Energy's Liabilities

Solid Energy owed the following amount in unsecured term debt (the Term Debt) to different banks:[29]

(1) ANZ in the amount of $40 million;
(2) BNZ in the amount of $80 million;
(3) CBA in the amount of $45 million;
(4) Westpac in the amount of $55.5 million;
(5) BTMU in the amount of $80 million.

ANZ, CBA and Westpac also issued unsecured performance bonds (the Performance Bonds) worth (in total) $58.4 million, which secured Solid Energy's remediation obligations to third parties.[30] This is described below as the contingent debt because Solid Energy was only liable to pay if it defaulted on the underlying obligations that the bonds were held in respect of.

For the purposes of the following analysis, the other most significant liability was the unsecured medium term notes (the Term Note indebtedness). This was similar to the

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[27] Section 232(3)(b) confers a power on the Court to invalidate the compromise because of a material, procedural irregularity.
[28] *Solid Energy*, above n 7, at [142].
[29] At [9].
[30] At [10].

above term debt owed to the banks. TSB was the most significant Term Note holder, holding $67.5 million of the total $95 million.[31]

Other obligations included a prospective settlement obligation in the amount of $23 million, rehabilitation liabilities in the amount of $145 million, a finance lease in the amount of $11.1 million and other general trade liabilities in the amount of $106 million.[32] ANZ and CBA had operating leases totalling $120 million, which were partially secured.[33]

E Voting Power in Compromises Proportionate to Debt Attribution

BTMU's portion of the Term Debt amounted to 26.62%. Therefore, BTMU would have had a blocking vote, had either of the compromise proposals solely addressed Term Debt.

Under the debt rescheduling compromise (the first proposal), the inclusion of the Performance Bonds (in the amount of $58.4 million) diluted BTMU's voting power to 22.29%.

Under the debt for equity exchange compromise (the second proposal), the removal of the Performance Bonds and inclusion of the Term Note indebtedness to TSB (in the amount of $67.5 million) diluted BTMU's voting power to 21.73%.

F Arrangements of Creditor Classes – BTMU's Arguments

In relation to the debt rescheduling compromise, the contingent Performance Bond indebtedness held by ANZ, CBA and Westpac was included at full voting power. As explained above, this diluted what otherwise would have been a blocking vote held by BTMU.[34] BTMU argued that the Performance Bond holders should have voted in a separate class in respect of that debt. Alternatively, the votes attached to that debt should have been discounted. This was because the holders of contingent debt have

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[31] *Solid Energy,* above n 7, at [10].
[32] At [10-11].
[33] At [11].
[34] At [144].

fundamentally different underlying interests. A holder of term debt has a crystallised interest in immediate or future recoupment of the money owed, whereas a contingent debt holder's interests lie in ensuring that the debtor is able to comply with its obligations in respect of which the contingent debt exists. BTMU argued that it was therefore impossible for the creditors to consult together with a view to their common interests.[35]

BTMU also argued that it was appropriate to apportion voting power to each bank based on the nature of their debts. The term debt of each bank would be apportioned full voting power, whereas the contingent debt would be apportioned a reduced voting power per dollar. This would fairly reflect the inherent uncertainty that the contingent debt obligations would ever fall due.[36]

Under the debt for equity exchange compromise, the inclusion of TSB's term note indebtedness (totalling $67.5 million) prevented BTMU from blocking the proposal.[37] BTMU argued that it was improper to include only the majority note holder and exclude the others (in the amount of $22.5 million). BTMU submitted that if the other term note holders had been included, it would have had a chance to persuade them to vote against the proposal.[38] If successful, BTMU and the excluded term note holders would have held 25.85% of the vote. Resultantly, they would have been able to veto the compromise.

BTMU also argued that ANZ and CBA should have voted in an entirely separate class because they were partially secured creditors. ANZ and CBA were secured to the extent that they had recourse to the asset under their respective operating leases.[39] BTMU believed it was inappropriate for ANZ and CBA as partially secured creditors, to vote in the same class as unsecured term debt creditors.

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[35] *Solid Energy*, above n 7, at [145].
[36] At [158].
[37] At [143].
[38] At [177-179].
[39] At [147].

BTMU also noted that there was no reason to leave contingent debt out of the debt exchange compromise, if it can be justifiably said there was no inherent difference between term and contingent debt.[40]

The Court rejected all of these arguments, finding against BTMU on the third cause of action.

VI Common Law Creditor Class Principles

A The Original Formulation of the "Common Interests" Test

Part 14, similar to its English and Australian counterparts, refers to separate classes of creditors, but contains no statutory definition of the constitution of a creditor class. At the time of hearing, the Companies Act contained no other indication as to what constitutes a creditor class.

The formulation of Bowen LJ's test in *Sovereign Life Assurance Company (in liq) v Dodd (Sovereign Life Assurance)*[41] was affirmed by *Solid Energy*[42] as the starting point for determining creditor classes in New Zealand:[43]

> "It must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest."

The relevant line of New Zealand case law can be traced back to this test. *Sovereign Life Assurance* has been affirmed as the starting point of authority in both the United Kingdom[44] and Australia.[45] The crux of the test is the focus on legal rights that creditors have against the company. A class must be able to consult together with a view to their common interests. This prevents certain creditors compelling creditors with dissimilar rights to be bound under the same compromise scheme.

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[40] *Solid Energy*, above n 7, at [146].
[41] *Sovereign Life Assurance Co (in liq) v Dodd* [1892] 2 QB 573 (CA).
[42] *Solid Energy*, above n 7, at [152].
[43] *Sovereign Life Assurance Co (in liq) v Dodd,* above n 41, at 582-583.
[44] *Re Hawk Insurance Co Ltd* [2001] EWCA CIV 241, [2002] B.C.C. 30 at [24].
[45] *Re Opes Prime Stockbroking Ltd (No 2)* [2009] FCA 813, (2009) 179 FCR 20 at [64].

The interpretation of the *Sovereign Life Assurance* test in subsequent English and Australian decisions is persuasive authority for the interpretation of s 230(1) of the Companies Act as the New Zealand Courts have adopted and affirmed this test.[46] Those principles have also been incorporated into Schedule 10[47] of the Act, inserted after the *Solid Energy* decision.

Schedule 10 outlines the relevant considerations for determining creditor classes for the purposes of amalgamations or arrangements involving Code Companies. Schedule 10 applies to s 236A[48], which governs court-sanctioned schemes for companies covered by the Takeovers Code. It is therefore not directly applicable to Part 14. However, it is still relevant as it effectively affirms the applicability of the established common law principles governing creditor classes in the New Zealand context. Schedule 10 expressly refers to the ability of creditors to consult together with a view to their common interests.

B The Comparator Rights Analysis

Re Hawk Insurance Co Ltd affirmed the importance of comparing the creditors' rights.[49] In each case, the creditors' ability to consult together with a view to their common interests depends on the nature of their incumbent rights prior to the compromise and any new rights that will accrue by way of the compromise.[50] The courts in the United Kingdom usually undertake what is now known as a class 'comparator' analysis.[51]

English authority sets out the approach to determining creditor classes in the context of a compromise proposal to rescue an insolvent company. There needs to be an assessment of the similarity or dissimilarity of the creditors' proposed legal rights under the compromise and their rights in the alternative scenario that the compromise

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[46] See, inter alia, *Solid Energy*, above n 7, at [152].
[47] Companies Act 1993, sch 10.
[48] Companies Act 1993, s 236A.
[49] *Re Hawk Insurance Co Ltd*, above n 44, at [24].
[50] At [30].
[51] Jonathan Cotton and Daniel Klineberg "Creditor schemes: the importance of class" (September 2007) Slaughter and May < www.slaughterandmay.com>.

does not go ahead.[52] The general tendency is to treat that scenario as winding-up or liquidation of the company. The courts generally compare the creditors' right upon winding-up or liquidation and their proposed rights under the compromise proposal. However, it has been suggested that if there is a viable alternative to liquidation, this may not be appropriate as a default comparator scenario. Such an alternative might be a more favourable compromise scheme.[53]

The Australian approach to the comparator analysis appears to support this proposition. The comparator situation does not appear to be restricted to liquidation. The applicable test is a comparison of the creditors' rights in the absence of the scheme and those that would exist or accrue under the compromise proposal.[54]

Therefore, the common interests test is not necessarily satisfied upon proving that creditors have similar rights both under the compromise and upon liquidation. Justice Winkelmann in *Solid Energy* appeared to conclude that the common interests test was satisfied. However, she focused only on the alternative of liquidation. Therefore, she may have ruled differently on BTMU's third cause of action if the rights of BTMU and the Performance Bond holders under the proposed compromise had been compared to their respective rights under a more favourable arrangement.

VII Application on the Solid Energy Facts

Justice Winkelmann dismissed all of BTMU's submissions in relation to the class issue.[55] Much of her reasoning is convincing. However, when considering BTMU's cumulative arguments, it is hard to avoid the inference that the creditor classes were gerrymandered in order to ensure steamrollering of BTMU's opposing vote. BTMU's submission that the rights and interests of the Term Debt holders were fundamentally different to those of the Performance Bond holders warrants closer analysis.

A Validity of Classing Term Debt and Contingent Debt Together

[52] *Re MyTravel Group plc* [2005] 2 BCLC 123 at [33].
[53] Jennifer Payne *Schemes of Arrangement: Theory, Structure and Operation* (1st ed, Cambridge University Press, Cambridge, 2014) at 202.
[54] *Re Opes Prime Stockbroking Ltd (No 2)*, above n 45, at [66].
[55] *Solid Energy*, above n 7, at [224].

BTMU submitted that the Performance Bond holders should have voted in a different class, in respect of their contingent debt. In other words, their voting power under the first compromise (debt rescheduling) should have been proportionally limited to their Term Debt. Term Debt holders, said BTMU, have an immediate interest in recoupment of their loan, whereas contingent creditors only have an interest in ensuring the debtor is able to comply with the underlying obligation in respect of which the performance bond has been issued and thus preventing the obligation to pay under the performance bond from ever arising.[56] BTMU relied on *Re Audax*[57] as authority for the proposition that prima facie, unsecured contingent creditors should vote in a separate class.

However, the contingency factor alone would appear insufficient to warrant a separate class meeting. The *Sovereign Life Assurance* decision is often cited as authority for the rule that contingent creditors and creditors with vested rights are automatically treated as belonging to separate classes. This is incorrect: the case is authority only for the proposition that, on the facts of the case, the rights of vested and contingent creditors were so dissimilar that it would have been inappropriate to class them together.[58] The paramount consideration is *similarity or dissimilarity in legal rights affecting the different creditors' abilities to consult together for their common interests* [emphasis added].[59]

The *Solid Energy* decision affirmed the ruling in *Re Hawk* that it is not enough to merely point to contingent and vested rights to justify class separation. It must be affirmatively shown that the creditors' rights are sufficiently dissimilar to warrant class separation, because they prevent consultation with a view to their common interests.[60] This is consistent with the English and Australian approaches. There are situations where the vested and contingent rights are in essence very similar, and where an absolute distinction would be arbitrary. Such a rule would have the practical effect of allowing creditors with vested rights to oppress majority intention. This

[56] *Solid Energy*, above n 7, at [145].
[57] *Re Audax Developments Ltd (in rec) (1990)* 5 NZCLC 66,798 (HC) at 66,803.
[58] *Re Hawk Insurance Co Ltd*, above n 44, at [29].
[59] *Solid Energy*, above n 7, at [30].
[60] At [30].

would be undesirable, for example, in a winding-up situation, where in practice the rights will become so similar that the creditors can consult together with a view to their common interest.

The following part of the essay examines whether BTMU and the Performance Bond holders should have voted in separate classes under the common interests test.

B Comparator Rights Analysis and the Approach of Winkelmann J

The approach of Winkelmann J was entirely consistent with the comparator rights analysis outlined in *Re MyTravel plc and Re Hawk*. Her final conclusion was that the rights given up by BTMU and the contingent creditors in respect of the performance bonds, as well as the rights they would each receive under the compromise proposal were parallel. She found that their respective rights were similarly affected under the debt rescheduling compromise and therefore they were able to consult together in view of their common interest.[61]

The comparative scenario used was that of liquidation. Once the company's assets were liquidated, the contingent obligations owed under the performance bonds would almost certainly have crystallised.[62] Resultantly, both the Term Debt holders and the contingent creditors had minimal chances of recovering their money from Solid Energy's assets. They both stood to lose a vast sum of money if the company were liquidated.[63]

The following points relating to the comparator analysis are therefore implicit in Winkelmann J's reasoning. Under the debt rescheduling compromise, the rights of BTMU and the contingent creditors were affected in the same way, by the extension of the date at which the principal of the term debt and crystallisation of any contingent liabilities would fall due. Despite BTMU's submission that Term Debt holders and contingent creditors have different interests arising directly out of their different legal rights, their rights were not so different that they could not consult together with

[61] *Solid Energy,* above n 7, at [162].
[62] At [168].
[63] At [162].

regard to a common interest. This was because if the compromise did not pass, the company would have been liquidated. Upon liquidation their rights would become indistinct from each other. The contingent creditors would become actual creditors with a similar prospect of recovering a portion of their debt to the same level as BTMU, as neither held any form of security in respect of their debt obligations.

The first point to note is the use of insolvent liquidation or winding-up as the comparator scenario. This is consistent with the English approach outlined in *Re MyTravel Plc*[64] *and Re Hawk.*[65] In most cases because of the nature of the financial position of the company, this is an appropriate comparison. However, the authorities do not limit the analysis to a liquidation or winding-up scenario. Academic opinion suggests that the approach is fact-specific. In some cases, there are other reasonable alternatives to liquidation that should also be considered. In Schemes of Arrangement: Theory, Structure and Operation, Jennifer Payne specifically outlines a more favourable compromise scheme as a possible example.[66]

As part of the proposal process, Solid Energy engaged KordaMentha[67] to prepare a report on Solid Energy's assets and liabilities. This report showed a positive net equity of approximately $75 million.[68] The threshold for putting forward a compromise proposal is expressed in terms of cash flow insolvency issues.[69] It was undisputed that there were cash flow insolvency issues to be addressed and that the threshold was satisfied.[70] However, liquidation may not have been the only alternative, based on the KordaMentha report, which showed balance sheet solvency. A more favourable scheme to BTMU and the other creditors may have been economically viable. This case is therefore distinguishable on its facts from *Re Hawk*. In *Re Hawk*, the comparable scenario was limited to an insolvent winding-up, because the petition for winding-up had already been put forward.[71] Lord Justice Chadwick's comments on this point support the notion that the alternative position is not always a

[64] *Re MyTravel Group plc*, above n 52.
[65] *Re Hawk Insurance Co Ltd*, above n 44.
[66] *Schemes of Arrangement: Theory Structure and Operation*, above n 53, at 202.
[67] KordaMentha is an advisory firm that specialises in restructuring and forensic support for companies.
[68] *Solid Energy*, above n 7, at [25].
[69] Companies Act, 1993 s 287.
[70] *Solid Energy*, above n 7, at [120].
[71] *Re Hawk Insurance Co Ltd,* above n 44, at [36].

winding-up. He considered this to be the right approach *in those circumstances* [emphasis added].[72]

BTMU submitted that the Crown should contribute some of the necessary equity rather than relying solely on the creditors.[73] Therefore, a comparative scenario whereby the Crown contributed all or some of the necessary finances should have been considered as a comparator.

It is reasonable to assume that BTMU would neither have risked nor allowed Solid Energy to go under. It would be contrary to its economic interests to refuse outright to compromise, in the hope of retaining a full claim to the debt, where its chances of recoupment were extremely slim.[74] BTMU apparently sought to secure a less one-sided compromise arrangement. It was one of Solid Energy's most significant creditors and stood to lose a significant amount of money. This is evidenced by its active and positive contributions in the working discussions concerning the financial issues faced by Solid Energy.[75] BTMU did not adamantly oppose the idea of a compromise itself, only a compromise whereby the creditors should be the ones to contribute the necessary equity. It believed that the company's state-owned nature warranted the Crown being the sole or at least a significant contributor.

There was therefore scope to consider other alternatives; the most relevant one being a scheme whereby the Crown contributed most of the necessary equity. It is impossible to say definitively how this would have affected the findings that the contingent creditors and the Term Debt holders were in the same class. Under such a scheme, the legal rights are arguably different enough to warrant division into different classes. BTMU and the other Term Debt holders would still have an immediate interest in recouping instalments and interest payable on the Term Debt. Conversely, the Performance Bond holders would not have an immediate claim to monetary satisfaction. Their rights accrued only in respect of the Performance Bonds being called up, and their interests lay in ensuring Solid Energy's continued ability to satisfy the underlying obligations.

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[72] *Re Hawk Insurance Co Ltd*, above n 44, at [36].
[73] *Solid Energy*, above n 7, at [22-26].
[74] At [23].
[75] At [25].

In summary, liquidation should not have been the only comparator scenario. It does appear that on that analysis, the rights of BTMU and the other creditors were similar. However, under a more favourable compromise scheme where the Crown contributed the necessary equity, the obligations Solid Energy owed to the Performance Bond holders may not crystallised. Therefore, the rights would have been significantly different.

VIII Overview of Statutory Compromise Regimes in the UK and Australia

The statutory regimes that govern compromises with creditors in the United Kingdom and Australia are broadly similar to Part 14. Voluntary administration regimes, similar to Part 15A[76], exist in both jurisdictions. However, the separate operation of Parts 14 and 15 is a concept unique to New Zealand. Part 15, additional to Part 14, confers a power on the court to approve a compromise proposal put to it on application.[77] This power is conferred in the broadest of terms. The court may make an order that a proposal of a company, shareholder or creditor is binding on persons or classes of persons as specified by the court, on terms that the court deems fit.[78] The section does not specify any mandatory considerations. However, the court takes the general approach that each class must be fairly represented, so as not to be coerced by the majority into a binding scheme.[79] This approach supports the proposition that the separate class voting provided for in Part 14 is a crucial element to prevent majority creditors forcing a compromise scheme on dissident minority creditors.

A United Kingdom

The Companies Act 2006 (UK) governs compromise with creditor schemes in the United Kingdom. On application under s 896(1)[80] the court may order a meeting of

[76] Companies Act 1993, pt 15A.
[77] Companies Act 1993, pt 15.
[78] Companies Act 1993, s 236(1).
[79] *Greymouth Petroleum Mining Co Ltd v Fletcher Challenge Ltd & Ors* [2001] 2 NZLR 786 (CA) at [42].
[80] Companies Act 2006 (UK), s 896(1).

the creditors or classes of creditors. The binding nature of a compromise scheme between a company's creditors or classes of creditors is subject to two requirements. The relevant part of the legislation is set out below:[81]

...

899 Court sanction for compromise or arrangement

(1) If a majority in number representing 75% in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting summoned under section 896, agree a compromise or arrangement, the court may, on an application under this section, sanction the compromise or arrangement.

(2) An application under this section may be made by—
(a) the company,
(b) any creditor or member of the company,
(c) if the company is being wound up or an administration order is in force in relation it, the liquidator or administrator.
(d) if the company is being wound up, the liquidator, or
(e) if the company is in administration, the administrator.

(3) A compromise or [arrangement] sanctioned by the court is binding on—
(a) all creditors or the class of creditors or on the members or class of members (as the case may be), and
(b) the company or, in the case of a company in the course of being wound up, the liquidator and contributories of the company.

…

The English process is notable for two reasons. First, the court oversees it entirely. The court has the power to intervene initially where the creditor classes have not been properly defined. Secondly, the court may only invoke its power to sanction the compromise where there has been a three-fourths majority vote in each class.

B Australia

The process in Australia under the Corporations Act 2001 (Cth) (Australia) is similar to the one in the United Kingdom. Where one of the specified parties advances a compromise proposal, the court has the power to order a meeting of creditors or meetings of the different classes of creditors.[82] The court may rule that a compromise

[81] Companies Act 2006 (UK), s 899.
[82] Corporations Act 2001 (Cth) (Australia), s 411(1).

proposal is binding upon the creditors or upon the class of creditors where the proposal is approved by a three-fourths majority of the creditors or of the class of creditors.[83] Therefore, a compromise will be binding only on a class of creditors whose vote has surpassed the necessary threshold and where the court has sanctioned it.[84]

c. Differences from New Zealand Procedure

In both the United Kingdom and Australia, an authorised party issues a proposal and applies to the court to order creditor meetings. If satisfied with the proposal, the court orders the necessary meetings. At a second hearing, the court sanctions the compromise, provided that the necessary majority vote has been obtained. This renders the arrangement binding on the creditors or class(es) of creditors that have approved it. The court supervision from the outset means that the classes must be properly defined for the court to even order creditor meetings.

Therefore, the class selection for the first application is fundamental. Before the court will order the separate meetings, it must be convinced that the classes have been properly selected.

The fundamental difference between these comparative processes and the New Zealand procedure is that there is no requirement for a judicial sanction under Part 14 of the Companies Act, although there are grounds for appeal following approval of the scheme. Section 232(3) [85] sets out the rights of individual creditors. Upon application, the court can make an order releasing an individual creditor from obligations under the compromise. This may be for insufficient notice given to the creditor pursuant to s 229,[86] a material irregularity in the way the compromise was obtained, or because the individual creditor was unfairly prejudiced or the class to which they belong was unfairly prejudiced by the compromise.

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[83] Corporations Act 2001 (Cth) (Australia), s 411(4).
[84] Corporations Act 2001 (Cth) (Australia), s 411(4).
[85] Companies Act 1993, s 232(3).
[86] Companies Act 1993, s 229.

The apparent lack of an effective safeguard against oppression of a minority in New Zealand is notable. In the UK and Australia the court orders the class meetings and if satisfied with the agreement, gives it the final seal of approval at the end. The giving of legislative force to the will and intentions of the majority of creditors in respect of a near-insolvent company's affairs is an important objective underlying Part 14.[87] However, the need for minority protection is inherent in such a process. The English judgments[88] consistently reiterate that the court's monitoring of the procedure and the requirement of a judicial sanction for the proposal to become binding, are an effective safeguard against oppression of the minority. The judgments also bear in mind that it is necessary to prevent unwarranted minority veto power for a compromise proposal, resultantly frustrating all intentions and expectations of the majority.[89]

It is worth noting that BTMU did argue unfair prejudice.[90] However, it could not show that its rights were in any way prejudiced differently to the rights of the other banks. Therefore, the unfair prejudice limb under s 232(3)(c)[91] was insufficient to protect its rights in this case. Had BTMU's submission that the classes were deliberately organised in such a way so as to ensure its opposing vote was overcome been successful, it could definitely have amounted to a material irregularity in the process pursuant to s 232(3)(b).[92]

In *Polperro Corporation Ltd v International Marine Services Ltd*, when considering what would amount to a material irregularity in the obtaining of approval of the compromise, Doogue J stated that the existence or non-existence of a majority is at the very heart of compliance with the requirements of Part 14.[93]

Based on the conclusion above that there was an alternative comparator that should have been considered, the argument can be made that there was not a sufficient majority of creditors *belonging to the same class* as BTMU, to bind BTMU to such a

[87] *Polperro Corporation Ltd v International Marine Services Ltd* HC Auckland CIV 2006-404-2390, 16 July 2007 at [45].
[88] See, inter alia, *Re Hawk*, above n 44.
[89] At [33].
[90] *Solid Energy*, above n 7, at [180].
[91] Companies Act 1993, s 232(3)(c).
[92] *Solid Energy*, above n 7, at [127].
[93] *Polperro Corporation Ltd v International Marine Services Ltd*, above n 87, at [45].

compromise arrangement. Therefore, it appears that it may have been improper to class BTMU and the other creditors together, and it therefore follows that BTMU should not have been bound by the compromises, because of this material irregularity.

IX Possible Modifications for the Statutory Regime

A The Need for Reform - Overview

In light of the *Solid Energy* decision, the law pertaining to Part 14 compromises with creditors is in need of some clarification or modification. Solid Energy was able to pass a relatively complex pair of compromise proposals, which addressed both the cash flow solvency issues as well as fundamental weakness in the company's balance sheet, to fundamentally restructure the company. Importantly, they were able to choose the classes of creditors with a considerable amount of latitude, to ensure a near-certain chance of majority approval.

The interpretation and application of the law in the *Solid Energy* decision allows a company's board too much leeway to pick and choose the constitution of the creditor classes. Such an interpretation is undesirable because it allows the steamrollering of the wishes of minority creditors.

B History of Part 14

The Companies Act 1993 was passed to replace its legislative predecessor, the Companies Act 1955. The Law Commission in its 1989 report entitled Company Law Reform and Restatement described the need for a complete overhaul of company law in New Zealand. This was based on its conclusions that the current regime was inaccessible and overly technical, much of the Act had become dated, and the Act was out of step with the general policy objectives of company law.[94]

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[94] Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989) at [26].

Part 14 was included in the draft bill to replace the existing procedure under s 205 of the Companies Act 1955.[95] One of the fundamental areas of concern was the proper level of court involvement in such a process. The existing procedure involved reasonably extensive court involvement. In line with the objectives of simplification and workability, the draft bill provided for three general function areas of court involvement, relevant to the Act as a whole. One of these was the power of the judiciary to grant remedies to dissentient minorities in cases of fundamental change or unfair prejudice.[96]

The compromise process was rarely attempted under s 205 because it was lengthy, complex and the degree of court involvement made it expensive.[97] Part 14 of the current Act was drafted with the intention of simplifying a process that was to operate as a constructive alternative to the liquidation of a company, which reflected the overarching reform objective of rendering the regime more accessible. The reform transformed the fundamentally supervisory role of the court, to one of review where specific grounds of appeal are satisfied.[98] Inherent in such a transition is the increased possibility of distortion of the process where it is unmonitored by the court. The Law Commission recognised that this process was very different to the one under s 205, but considered the current s 232(3)(c), which gives the court a residual power to invalidate a compromise on the basis that a creditor was unfairly prejudiced, to be sufficient to prevent abuse of the new procedure.[99] Such recognition was necessary in light of the Law Commission's concern that public perception of the former companies regime was tainted by the scope for abuse of process.[100] However, as illustrated by the *Solid Energy* decision, there is still scope for abuse of process, as the current regime gives the debtor company too much latitude to lump different creditors together.

C Unsatisfactory Current Protection for Minority Creditors

[95] Companies Act 1955, s 205.
[96] *Company Law: Reform and Restatement*, above n 94, at [136].
[97] At [635].
[98] At [635].
[99] At [638].
[100] At [26].

In practice the unfair prejudice ground for appeal does not prevent abuse of the process. Where court oversight through approval prevents procedural abuse throughout the process, the unfair prejudice ground prevents abuse only where a dissident creditor actually appeals the compromise. There are numerous reasons a particular creditor may choose not to do so, in particular the cost of bringing an appeal against an effected compromise. There is a large disparity between the two approaches in respect of the scope for prevention of abuse of process.

Furthermore, even where an appeal is brought against a compromise under s 232(3)(c), the unfair prejudice provision is not a wide-enough catchall to cover all possible situations of abuse of process. In *Solid Energy*, BTMU did in fact argue unfair prejudice as its fourth cause of action.[101] Justice Winkelmann rejected this submission. The crux of s 232(3)(c) lies in the creditor satisfying the court that they have been *treated differently to other creditors* [emphasis added].[102] BTMU, like the other banks was lumped into the syndicated facility agreement and incurred the same proportionate reduction of its debt. Justice Winkelmann did state that gerrymandering of the classes *might* amount to an abuse of process for the purposes of s 232(3)(c). However, this contention was rejected because she did not believe there was sufficient evidence of gerrymandering to consider the argument further.[103]

In light of the *Solid Energy* decision, the abuse of process ground of appeal is too limited in scope to properly protect the rights of dissentient minority creditors. Therefore, because of the undesirable conclusion in *Solid Energy*, which effectively sanctioned the steamrollering of minority rights, the process needs to be reformed.

In 2001, the Law Commission released a report entitled Insolvency Law Reform: Promoting Trust and Confidence.[104] The paper comprehensively analysed the background to insolvency, the New Zealand context and the corporate rescue regime. The Law Commission's analysis primarily addressed submissions on the workability

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[101] *Solid Energy*, above n 7, at [180].
[102] At [191].
[103] At [187].
[104] Law Commission *Insolvency Law Reform: Promoting Trust and Confidence* (NZLC SP11, 2001).

of Part 14 and Part 15, as well as whether Parliament should introduce a new, more targeted regime.[105]

This essay suggests four options for refinement of the process, in order to better protect minority rights, which are discussed in the following paragraphs. These are discussed in the context of the Law Commission's report on the general principles and objectives of insolvency law.

X Options for Reform

A Court Sanction Requirement

One possibility would be to entirely revert to the English and Australian approach and require court involvement from the outset. This would involve an application to the court to order meetings of creditors or classes of creditors. Once the meetings had been held, and the necessary majorities obtained, a further application would be required for court sanction of the compromise to render it binding. Such an approach is undoubtedly an effective safeguard against oppression of dissident creditors. However, this ignore the Law Commission's objectives[106] underlying Part 14, of creating a compromise with creditors process that facilitates corporate rescue in a constructive, less costly and less time-consuming manner.

It is however possible to strike a balance between the approaches of other Commonwealth jurisdictions and the New Zealand focus on efficacy and cost reduction, noting that the importance of these considerations was reiterated by the Law Commission in its analysis of insolvency in the New Zealand context.[107]

This could be done by having court involvement in initial stages of the process. The initial step in Part 14 could be an application to the court to order meetings of creditors or creditor classes, whereby it would be necessary to prove that the classes had been properly defined, similar to the United Kingdom. However, a later judicial

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[105] *Insolvency Law Reform: Promoting Trust and Confidence*, above n 104, at [244].
[106] *Company Law: Reform and Restatement*, above n 94, at [148].
[107] *Insolvency Law Reform: Promoting Trust and Confidence*, above n 104, at [21].

rubber stamp on the agreed proposal would not be required. Once the meetings have been ordered, the subsequently agreed compromise proposal would be binding upon majority approval. This would be a less costly approach than the United Kingdom, requiring only one court application rather than two.

This process would obviously not be quite as cost-effective as the current Part 14. However, the costs must be balanced against the necessity of a judicial safeguard against improper use of the process. It would also mitigate the Law Commission's concerns about public perception of the potential for abuse of process to occur.[108]

B A Separate Regime for Certain Types of Companies

It is arguable that the nature of some companies means they warrant treatment under an entirely separate regime. This may be because of the inherent value in their continued operation, the nature of their makeup, or the significant negative implications of their winding-up or liquidation. The Law Commission suggested that this may be the case for state-owned enterprises or suppliers of strategic infrastructure, such as rail and water providers.[109] The report does not detail how such a regime would function but the idea is meritous. When a state-owned enterprise strikes financial trouble, the stakes are much higher. It therefore follows that judicial motivation to facilitate its rescue will be much higher.

This may well have been a policy consideration implicit in Winkelmann J's decision. It would be preferable to have a separate regime that recognised these concerns rather than allow Part 14 to be used in a way that is potentially unfair to minority shareholders of all types of companies, including those to which these concerns do not apply.

C Limitation of Part 14 to Small Companies or a Maximum Amount of Debt Owing

[108] *Company Law: Reform and Restatement*, above n 94, at [26].
[109] *Insolvency Law Reform: Promoting Trust and Confidence*, above n 104, at [244].

A fundamental similarity between the Law Commission's analyses prior to and following enactment of the Companies Act 1993 is the focus on rendering the creditor compromise process as streamlined and cost-effective as possible. In its 2011 report, the Commission concluded that there was no need to alter Part 14. This was because nothing could be done to make the process any simpler or less costly, particularly for small business.[110] The Law Commission did recommend the implementation of an alternative rehabilitation regime, which would be tailored towards larger businesses, but could be utilised by smaller businesses provided they met the threshold requirements.[111]

The emphasis on facilitating access to rehabilitation processes for smaller enterprises is recurrent in the report. This is indicative of the nature of commerce in New Zealand. The majority of businesses can be classed as small.[112] Therefore, Part 14 is desirable in the sense that it achieves these objectives. However, constraining its operational scope may create more certainty in the process as well as preventing similar outcomes to that in the *Solid Energy* decision. For example, the threshold for using the process could be expressly limited to compromises designed to address cash flow insolvency. This would prevent complex restructuring objectives from being passed under Part 14, which are more suited to a process involving judicial oversight.

Another possibility would be to limit the application of Part 14 to creditor compromises concerning small companies by reference to their total outstanding monetary liabilities to creditors. For example, Part 14 could be expressly limited to situations where the total aggregation of debts that the company wished to compromise did not exceed a certain amount, for example $5,000,000. This would have the effect of limiting the process to use in the types of situations envisioned above, where a smaller business wished to pass a simple compromise arrangement between its creditors in order to trade its way out of insolvency. Larger businesses would still have the option of using either Part 15 or 15A.

D Increased Threshold for Creditor Approval

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[110] *Insolvency Law Reform: Promoting Trust and Confidence*, above n 104, at [224].
[111] At [244].
[112] At [229].

If Part 14 were left to stand as it is, it would be desirable to tighten the process. In the interests of minority protection, one option would be to increase the necessary majority approval to 85%. The counter-argument is that this increases the potential for minority oppression by an even smaller pool of dissident creditors, which is an issue that has been of significant concern to the English courts. Increasing the necessary majority for approval would make it significantly harder to cherry-pick the creditor classes to ensure that a minority vote is blocked. However, in light of the fundamentally different and unsanctioned Part 14 process, it is arguably fairer in respect of the interests of minority creditors to add such a requirement alongside the possibility for appeal at the end of the process. It adds another level of inherent minority protection to the process, which in the United Kingdom and Australia is provided for by the two court application requirements.

E The Preferable Option

This essay proposes that the best option is to reform the process to require an initial application to the court at which the court may order a meeting or meetings of creditors or classes of creditors. To have an initial level of court supervision inherently prevents steamrollering of the rights of minority creditors, because there is judicial supervision of class separation from the outset.

This would be more cost-effective than the double application process in the United Kingdom and Australia as it does not require a second application for the Court to rubber-stamp the final agreement. As a further protection for creditors, the provision could require the applicant company to prove affirmatively that the common interests test is satisfied, before the court orders a meeting or meetings.

XI Conclusion

It is arguable under the English comparator rights analysis that the Part 14 compromise schemes proposed in the *Solid Energy* case were validly approved under the current legislation. This is primarily because creditors were classed together on

the basis that they had common interests, viewed in the context of an alternative to the passage of the compromise agreements being liquidation of the company.

However, a closer analysis reveals that in this situation, liquidation might not have been the appropriate comparator situation. Justice Winkelmann's decision could be challenged in this respect. The fact that the alternative scenario was not necessarily liquidation puts her conclusion that the rights of the vested and contingent creditors were sufficiently similar to consult together towards their common interests on shaky ground.

In any event, the *Solid Energy* decision is undesirable in the sense that it appears to give a company considerable scope to cherry-pick the creditor classes for a compromise arrangement, in order to boost its own chances of obtaining the necessary 75% majority approval.

In order to protect minority rights, the time has come for some reform, clarification or constraint of the Part 14 compromise with creditors process. It must be borne in mind that Parliament intended Part 14 to be a cost-effective and workable process. However, it is also important not to endanger the rights of minority creditors in order to cut costs. A way to achieve these objectives is to require application for a court order to commence the compromise process, as outlined above.

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